(1)

No. ___

Supreme Court, U.S.
FILED
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IN THE

Supreme Court of the United States

SUSAN MORAN, *et al.*,
Petitioners,

v.

J. ELLIOTT HIBBS, *et al.*,
Respondents.

On Petition for Writ of Certiorari to the Supreme Court of Arizona

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PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether state taxation of the mandatory retirement plan contributions of federal civilian employees violates 4 U.S.C. § 111 (2000) when the mandatory retirement plan contributions of identically-situated state and local government employees are exempt from state tax.

PARTIES TO THE PROCEEDING

The parties to the consolidated proceedings below were the taxpayer plaintiffs, Clark J. Kerr, his wife, Billie Sue Kerr, Susan Moran, Steve Allen and John Udall. The action was brought as a class action on behalf of each of the taxpayer plaintiffs and the approximately 42,000 similarly circumstanced federal employees in the State of Arizona. The defendants included Mark J. Killian in his official capacity as the Director of the Department of Revenue and the Arizona Department of Revenue. The Department of Revenue also appeared as a plaintiff with respect to its claim concerning the tax year 1984. The taxpayer plaintiffs and the law firms of Bonn, Luscher, Padden & Wilkins, Chartered, its successor in interest, Bonn & Wilkins, Chartered, and O'Neil, Cannon & Hollman, S.C. maintained counterclaims against the Department of Revenue regarding attorney fees. Mr. Kerr did not work for the federal government after 1990 and therefore, he and his wife are not petitioners here. Petitioners Susan Moran, Steve Allen and John Udall continued as federal employees for years after 1990. Mark J. Killian has been succeeded as Director of the Arizona Department of Revenue by J. Elliott Hibbs, who is thus named as a respondent in his official capacity as Director of the Arizona Department of Revenue.

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
PARTIES TO THE PROCEEDING	ii
TABLE OF AUTHORITIES	iv
OPINIONS BELOW	1
JURISDICTION	2
STATUTORY PROVISIONS INVOLVED	2
STATEMENT OF THE CASE	3
REASONS FOR GRANTING THE WRIT	7
CONCLUSION	15
APPENDICES	
Appendix A	1a
Appendix B	23a
Appendix C	50a
Appendix D	70a
Appendix E	74a
Appendix F	88a
Appendix G	107a
Appendix H	154a
Appendix I	157a
Appendix J	164a

TABLE OF AUTHORITIES

CASES — Page

Barker v. Kansas, 503 U.S. 594 (1992).....7, 13-14
Davis v. Michigan Dep't of Treasury, 489 U.S. 803 (1989).....3, 7, 8, 9, 10
In re Estate of Alarcon, 718 P.2d 989 (Ariz. 1986)..... 6
Graves v. People of State of New York, ex rel O'Keefe, 306 U.S. 466 (1939)..... 10
Harper v. Virginia Dep't of Taxation, 509 U.S. 86 (1993)..... 8, 13
Jefferson County v. Acker, 527 U.S. 423 (1999).....10, 12, 14
Kraft Gen. Foods, Inc. v. Iowa Dep't. of Revenue, 505 U.S. 71 (1992)..... 14
McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819)..... 10
Memphis Bank & Trust Co. v. Garner, 459 U.S. 392 (1983)..... 12
South Carolina v. Baker, 485 U.S. 505 (1988)..... 10
Thurston v. Judges' Ret. Plan, 876 P.2d 545 (Ariz. 1994)..... 13
United States v. City of Detroit, 355 U.S. 466 (1958)..... 10
Yeazell v. Copins, 402 P.2d 541 (Ariz. 1965)..... 13

STATUTES

4 U.S.C. § 111 (2000)..... i, 4, 6
26 U.S.C. § 414(h) (2000).....5, 6, 8, 14
28 U.S.C. § 1257(a) (2000)..... 2
Ariz. R. Civ. App. P. 23(a) (2004)..... 6
Ariz. Rev. Stat. § 38-792 (2004)..... 4-5
Ariz. Rev. Stat. § 43-1001(2) (2004)..... 5, 12
Ariz. Rev. Stat. § 43-1021 (2004)..... 5
Ariz. Rev. Stat. § 43-1022 (2004)..... 5, 11

TABLE OF AUTHORITIES—Continued

	Page
Kan. Stat. Ann. § 79-32, 117(b)(vi) (2003)	8
Me. Rev. Stat. Ann. tit. 36, § 5122(G) (West 2003)	8
Mass. Gen. Laws Ann. ch. 32 § 22(10) (2004)	8
Mass. Gen. Laws Ann. ch. 62, § 2(a)(1)(1) (2004)	8
Md. Code Ann., Tax-Gen. § 10-204(f) (2003)	8
N.Y. Tax Law § 612(b) (26) (Consol. 2004)	8

OTHER AUTHORITIES

Brief *Amici Curiae* of the States of Arizona and North Carolina in support of *Virginia Department of Taxation*, U.S. No. 91-794 (Sept. 8, 1992)	13
G.C.M. 39,540 (Jul. 25, 1986)	11
http://opm.gov/feddata/geograph/table3.pdf (visited Apr. 27, 2004)	8
Re: § 58.1-1821 Application: Indiv. Income Tax, P.D. 94-354, 1994 Westlaw 722715 (Va. Dep't Tax. Nov. 23, 1994)	8, 11

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PETITION FOR WRIT OF CERTIORARI

Susan Moran, Steve Allen and John Udall, on behalf of themselves and all others similarly situated, respectfully petition this Court for a writ of certiorari to the Supreme Court of Arizona.

OPINIONS BELOW

The opinion of the Supreme Court of Arizona is reported at 84 P.3d 446 (2004). App 1a–22a. The amended decision of the Arizona Court of Appeals is reported at 65 P.3d 434 (Ariz. Ct. App. 2001). App. 23a–49a. The initial decision of the Arizona Court of Appeals in this case is reported at 32 P.3d 408 (Ariz. Ct. App. 2001). App. 50a–69a. The Judgment of the Arizona Superior Court on the parties' cross motions for summary judgment is unreported. App. 70a–73a. For the sake of completeness, prior opinions of the Arizona Court of Appeals, which provide additional historical background of this controversy and litigation, are reported at

3 P.3d 1133 (Ariz. Ct. App. 2000), App. 74a–87a; 916 P.2d 1173 (Ariz. Ct. App. 1996), App. 88a–106a; and 899 P.2d 162 (Ariz. Ct. App. 1994). App. 107a–153a.

JURISDICTION

The opinion of the Supreme Court of Arizona was entered on February 13, 2004. This petition is, accordingly, filed within the time allowed by law. Jurisdiction to review the decision in this case by writ of certiorari is conferred upon this Court by 28 U.S.C. § 1257(a) (2000).

STATUTORY PROVISIONS INVOLVED

Title 4, United States Code, section 111 provides, in relevant part:

> The United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States . . . by a duly constituted taxing authority having jurisdiction, if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation.

Title 26, United States Code, section 414(h) provides, in relevant part:

> Tax treatment of certain contributions.—
>
> (1) In general.—Effective with respect to taxable years beginning after December 31, 1973, for purposes of this title, any amount contributed—
>
> (A) to an employees' trust described in section 401(a), or
>
> (B) under a plan described in section 403(a), shall not be treated as having been made by the employer if it is designated as an employee contribution.
>
> (2) Designation by units of government.—For purposes of paragraph (1), in the case of any plan established by the government of any State or political subdivision

> thereof, or by any agency or instrumentality of any of the foregoing, where the contributions of employing units are designated as employee contributions but where any employing unit picks up the contributions, the contributions so picked up shall be treated as employer contributions.

Pertinent provisions of the relevant state statutes are set forth at App. 157a–163a.

STATEMENT OF THE CASE

This litigation arose in the wake of this Court's decision in *Davis v. Michigan Dep't of Treasury*, 489 U.S. 803 (1989). In *Davis*, this Court invalidated Michigan's taxing scheme that discriminated in favor of local and state government retirees and against federal retirees. *Id.* at 817. This case, like *Davis*, involves a taxing scheme shared by over 20 states that affects over a million federal employees. But unlike *Davis*, this case involves discriminatory state taxation of the *current* compensation of federal employees.

Arizona, like most governmental employers, offers contributory pension plans for its employees. In order for state and local pensions plans to be "qualifying" under the Internal Revenue Code, they must include both employer and mandatory employee contributions. Thus, like the federal pension plans, Arizona's plans include both employer and mandatory employee contributions. Unlike the federal plans, however, Arizona is authorized under the Internal Revenue Code, and has opted, to pick up the payment of the employees' mandatory contribution. For federal income tax purposes only, the mandatory contribution "picked up" by the state is excluded from federal adjusted gross income.

In addition to picking up employees' mandatory contributions, since as far back as 1943 Arizona has also exempted this portion of state employees' compensation from state income tax. This exemption applies currently to *all* state

and local employees in the State of Arizona.[1] Arizona does not provide a similar exemption for federal employees. Thus, Arizona state and local employees pay no state income tax on the portion of their compensation representing the employee mandatory contribution to their pension plan while federal employees pay income tax to the State of Arizona on that identical portion of their current compensation. Under Arizona's tax scheme, for example, a hypothetical federal employee who earned $100,000 and who made a seven per cent retirement contribution would pay state income tax on the full $100,000 salary; an identically situated state employee would pay state income tax only on $93,000 of his $100,000 salary.

This discriminatory treatment arises out of two independent statutory bases. First, the exemption from income tax for current state and local employees is contained in the statutory provisions of the various state retirement plans themselves. Just as Arizona formerly provided a statutory exemption for the pensions of state and local employees, it currently provides in the various pension statutes exemption from taxation for the mandatory employee contribution. *See* App. 7a n.6 ("In addition to the subtractions from income previously set forth [in the state tax code] for contributions to state retirement plans, the statutes governing [the state retirement plans] have long provided that member contributions 'are exempt from state, county and municipal taxes.'") (citation omitted). *See also* Ariz. Rev. Stat. § 38-

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[1] Between 1991 and 1999, new hires in two small retirement plans were not provided this exemption. During this same period, well over 180,000 state and local government employees were exempt from the tax. Until 1990, Arizona also provided an express subtraction in its income tax code for State employees' mandatory contributions. However, the State confessed judgment as to those years, acknowledging that Arizona's discriminatory scheme violated 4 U.S.C. § 111 and the intergovernmental tax immunity doctrine because of the express subtraction.

792 (2004) ("The member and employer contributions . . . are exempt from state, county and municipal income taxes.") App. 160a.

The second source of the exemption for state and local government employees is Arizona's adoption of the federal adjusted gross income from the Internal Revenue Code as the starting point for determining Arizona gross income. *See* Ariz. Rev. Stat. § 43-1001(2) (2004) ("'Arizona gross income' of a resident individual means the individual's federal adjusted gross income for the taxable year, computed pursuant to the internal revenue code.").[2] Under 26 U.S.C. § 414(h), employee retirement contributions of state and local governments "picked up" by the employer are excluded from federal adjusted gross income. Accordingly, in Arizona (and many other states), that portion of state and local employees' compensation representing their mandatory retirement contribution is excluded from federal adjusted gross income, and thereby escapes state taxation. There is no Arizona income tax subtraction that permits federal employees to subtract their mandatory contributions from Arizona gross income, nor is there a provision that requires State employees to add their mandatory contributions back in to equalize the treatment of the two groups.

Thus, this case arises in this Court on the undisputed record that Arizona taxes the current compensation of all federal employees representing their mandatory contributions to federal retirement systems, while exempting from taxation the identical element of compensation of its own employees. Not only is this discrimination uncontroverted, but so too it is conceded that the mandatory contributions of state and local

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[2] The Arizona legislature also provides numerous subtractions and additions to determine Arizona gross income, including, for example, subtractions for interest from federal obligations and Railroad Retirement Benefits. *See, e.g.*, Ariz. Rev. Stat. §§ 43-1021 and 43-1022 (2004).

government employees are substantively indistinguishable from the mandatory contributions of federal employees and that 26 U.S.C. § 414(h) does not affect what is compensation.[3]

After years of procedural skirmishes, in 2000 the taxpayers were finally able to obtain a ruling on the merits of their claim. The trial court sustained their challenge, held that Arizona's discriminatory taxation scheme violated 4 U.S.C. § 111 and the doctrine of intergovernmental tax immunity, and ordered the State to pay refunds. App. 72a. Ultimately, the Arizona Court of Appeals affirmed the trial court. App. 24a. Yet the Arizona Supreme Court, on the State's jurisdictionally untimely petition for review,[4] reversed the lower courts. Despite the overwhelming evidence and admissions by the State to the contrary, the Supreme Court of Arizona concluded that Arizona's discriminatory income tax scheme does not discriminate against federal employees because of the source of their compensation. App. 2a. The Arizona Supreme Court reasoned that the only impediment to federal employees receiving the same tax treatment as State employees was Congress's failure to "pick-up" federal employees' mandatory contributions. The court concluded that when and if Congress changes federal law, Arizona will then treat federal employees equally. App. 19a.

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[3] For example, the State conceded below that the mandatory contributions are part of a state or local government employee's compensation, including for purposes of retirement benefits calculations, workmen's compensation, vacation pay, sick pay, unemployment insurance and social security benefits. *See* Petitioners' Cross-Motion for Summary Judgment.

[4] Arizona law provides that a party must seek review within 15 days of the mailing of a determination on reconsideration. *See* Ariz. R. Civ. App. P. 23(a) (2004). *See also In re Estate of Alarcon*, 718 P.2d 989 (Ariz. 1986). The State's petition was due by March 17, 2003 but it was not filed until March 31, 2003. The Supreme Court of Arizona denied the taxpayers' motion to dismiss the State's petition without comment.

Because the Arizona Supreme Court's decision is fundamentally flawed, and because its decision validates a discriminatory taxation scheme prevalent throughout the Untied States, the taxpayers bring this petition for a writ of certiorari.

REASONS FOR GRANTING THE WRIT

This case presents questions of substantial public importance concerning the practice of Arizona, and twenty-eight other states, of discriminatorily taxing the mandatory retirement contributions of federal employees' current compensation. In *Davis v. Michigan*, 489 U.S. 803, 817 (1989), this Court held that states could not tax the annuities of retired federal employees if they exempted the annuities of state and local government employees from state taxation. This case is essentially indistinguishable from *Davis*, with the exceptions that here the discrimination affects the *current* compensation of federal employees, not their pensions, and, because the discriminatory practices are more pervasive among the states, the discrimination affects more federal employees.

With its decision below, the Supreme Court of Arizona has flouted this Court's holdings in *Davis v. Michigan*, and *Barker v. Kansas*, 503 U.S. 594 (1992), among others. So too, in holding that it is Congress's burden to cure the discrimination by altering its compensation schemes for federal employees, the court below has turned the doctrine of intergovernmental tax immunity on its head. Review by this Court is necessary to bring Arizona law into conformity with the decisions of this Court and to end its practice of discriminating against the United States and those with whom it deals.

1. In *Davis v. Michigan*, this Court invalidated Michigan's discriminatory taxation of federal retirement benefits. At the

time the Court decided *Davis*, 23 states gave preferential tax treatment to benefits received by state and local government retirees relative to the tax treatment received by federal employees. *Harper v. Virginia Dep't of Taxation*, 509 U.S. 86, 93 (1993).

Arizona's challenged tax, in contrast to *Davis*, affects the *current* compensation of some forty-plus thousand federal employees.[5] But, as in *Davis*, Arizona's discriminatory tax scheme is not unique. Indeed, far from it—it appears that there are at least 28 additional states that have adopted tax schemes similar to Arizona's that discriminate against federal employees by providing an exemption for the mandatory retirement contributions of state and local government employees. App. 167a–169a. Thus, this case implicates the interests of over a million current federal employees across the nation.

Some states that, like Arizona, have adopted the federal Adjusted Gross Income as the starting point for determining state tax liability, have nonetheless corrected for this discrimination.[6] Maryland, for example, specifically requires state employees to add to their Maryland adjusted gross income amounts "excluded from federal adjusted gross income under [26 U.S.C.] § 414(h)(2)." Md. Code Ann., Tax-Gen. § 10-204(f)(2) (2003). Virginia, in contrast, makes no such correction—indeed, its Tax Commissioner has specifically ruled that it need not do so. *See* Re: § 58.1-1821 Application: Indiv. Income Tax, P.D. 94-354, 1994 Westlaw 722715 (Va. Dep't Tax. Nov. 23, 1994). California, which

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[5] State-by-state federal employment statistics as of December 31, 2000 are available at http://opm.gov/feddata/geograph/table3.pdf (visited Apr. 27, 2004).

[6] *See, e.g.*, Mass. Gen. Laws Ann. ch. 62, § 2(a)(1)(1) and ch. 32 § 22(10) (2004); N.Y. Tax Law § 612(b) (26) (Consol. 2004); Kan. Stat. Ann. § 79-32, 117(b)(vi) (2003); Me. Rev. Stat. Ann. tit. 36, § 5122(G) (West 2003); Md. Code Ann., Tax-Gen. § 10-204(f)(1) and (2) (2003).

has the highest number of federal employees (nearly a quarter million), joins Virginia and Arizona in discriminatorily taxing federal employees.

This widespread difference in treatment among the states impacts over a million federal employees nationwide. So too, it directly implicates the interests of the United States—as this Court recognized in *Davis*, "[t]axes enacted to reduce the State's employment costs at the expense of the federal treasury are the type of discriminatory legislation that the doctrine of intergovernmental tax immunity is intended to bar." 489 U.S. at 815 n.4. Review by this Court is necessary not only to resolve this issue of inconsistent application from state to state but also to ensure that the United States is not involuntarily subsidizing the employment costs of state governments.

2. The court below held that Arizona's discrimination was not based on the source of federal employees' income; rather, it held, the discrimination was based on Congress's allowing states to "pick up" employee contributions and its decision not to "pick up" the contributions of federal employees. App. 18a. Thus, the court held, Congress was free to cure the discrimination simply by changing the way in which it compensates federal employees: "When and if the federal employer makes the same choice [to pick up the employee contribution], Arizona tax law will treat its employees' contributions in an identical fashion." App. 19a.

This holding defies the precedent of this Court. Indeed, it turns the doctrine of intergovernmental tax immunity on its head—it is the states' responsibility, not Congress's, to ensure that they do not discriminate against the United States or those with whom it deals. Review by this Court is necessary to ensure that this perversion of the law of intergovernmental tax immunity, which has already been adopted by at least one other state, does not gain currency.

As this Court has held "from the time of *McCulloch v. Maryland*,"[7] the intergovernmental tax immunity doctrine "barred taxes that 'operat[e] so as to discriminate against the Government or those with whom it deals.'" *Davis v. Michigan*, 489 U.S. at 812 (quoting *United States v. City of Detroit*, 355 U.S. 466, 473 (1958)). While this doctrine has now been codified in 4 U.S.C. § 111, the prohibition against discriminatory state taxation has been, and continues to be, a constitutional imperative. Moreover, in all of this Court's jurisprudence, the doctrine has always been characterized as one of *immunity* from state taxation. As such, it is not a matter subject to states' control or conditions. Rather, this is an area "over which Congress is the principal superintendent." *Jefferson County v. Acker*, 527 U.S. 423, 437 (1999).

Indeed,

> the federal tax immunity has always been greater than the States' immunity. The Federal Government, for example, possesses the power to enact statutes immunizing those with whom it deals from state taxation even if intergovernmental tax immunity doctrine would not otherwise confer an immunity. *See, e.g., Graves v. People of State of New York, ex rel O'Keefe*, 306 U.S. 466, 478 (1939). The States lack any such power.

South Carolina v. Baker, 485 U.S. 505, 520 n. 11 (1988). As a corollary to this greater immunity, the United States has always been free to discriminate in matters of taxation against itself and those with whom it deals. For example, the federal government has taxed income from federal bonds while not taxing income from state bonds, but that fact gives the States no power to discriminate. *Id.* Arizona recognizes this limitation on its taxing power by its subtraction for interest

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[7] 17 U.S. (4 Wheat.) 316 (1819).

received from federal obligations. *See* Ariz. Rev. Stat. § 43-1022 (2004).[8]

The court below suggests that Arizona will cease discriminating against federal employees when Congress changes its compensation schemes for federal employees. App. 19a. So too, the Virginia Tax Commissioner has opined that Virginia will stop discriminating when "Congress decides to offer" a pension plan similar to Virginia's. P.D. 94-354, 1994 Westlaw 722715, at 2. But it is not Congress's burden to structure compensation for federal employees in such a way that it mirrors how any particular state has chosen to compensate its employees. Rather, it is the states' *privilege* to impose an income tax on federal employees, but only to the extent that they do so in a non-discriminatory fashion.

The decision of the court below, mirrored by Virginia, threatens to erode the government's immunity to the point of meaninglessness. Congress cannot possibly structure the compensation of federal employees in such a way that it is identical to that chosen by all 50 states and countless other governmental entities. Nor, of course, should it be required to do so as a condition of obtaining equal tax treatment for federal employees. Review by this Court is necessary to forestall Arizona's attempt to impose an impermissible burden on the United States and to ensure that it remains the states' burden to structure their tax schemes so that they do not discriminate against the United States or those with whom it deals.

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[8] The federal government in the exercise of its sovereignty has provided a federal tax benefit for federal income tax purposes *only*. *See* G.C.M. 39,540 (Jul. 25, 1986) ("414(h) is only relevant to federal tax treatment and does not bind the state. . . ."). Therefore, there is no basis for the conclusion below that Congress's action may be deemed a ground upon which to claim that it excuses what is plainly discriminatory.

3. The decision below also misinterprets this Court's decision in *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392 (1983). The court below suggests that the intergovernmental tax immunity doctrine applies only to statutes that discriminate on their face against a federal interest. App. 16a. However, that is not the case. This Court has repeatedly admonished courts that in determining whether a tax violates the federal government's constitutional immunity, they "'must look through form and behind labels to substance.'" *Jefferson County v. Acker*, 527 U.S. 423, 439 (1999) (citation omitted). This Court has never constrained the tax immunity doctrine in such a fashion, which would essentially be an open invitation to the states to engage in clever drafting to conceal their discrimination.

Here, the substance of Arizona's proffered rationale fails constitutional muster for precisely the same reason that Tennessee's scheme failed in *Memphis Bank*. 459 U.S. at 398-99. Arizona's scheme operates to discriminate in favor of its employees and against federal employees by including in the tax base *all* income of federal employees while excluding from the tax base an identical element of income of state and local government employees. *See id.* ("The State [discriminates] by including in the tax base income from federal obligations while excluding income from otherwise comparable state and local obligations. We conclude, therefore, that the Tennessee bank tax impermissibly discriminates against the Federal Government and those with whom it deals.") (footnote omitted).[9]

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[9] The decision's suggestion (App. 16a) that Ariz. Rev. Stat. § 43-1001(2) (2004) contains no overt discrimination is untenable. As the record establishes, including the admissions of the State's pension expert, having adopted the federal definition as its tax base, under both a literal reading and a consideration of the tax provision's practical operation, if a taxpayer is not an employee of the state or one of its local subdivisions,

The court below simply glossed over Arizona's independent statutory basis for the discrimination. Under long-standing principles of Arizona law, the statutory provisions of the State's retirement plans are part of an employee's employment contract and are fully vested at the date of employment. *Thurston v. Judges' Ret. Plan*, 876 P.2d 545, 546 (Ariz. 1994); *Yeazell v. Copins*, 402 P.2d 541, 544 (Ariz. 1965).[10] Changes that disadvantage employees can operate only as to future employees. *Yeazell*, 402 P.2d at 546. Thus, every state and local government employee who enjoyed the exemption in 1990 has also enjoyed the exemption throughout the period in issue. App. 157a–163a.

At bottom, the court's failure to address the independent second source of discrimination clearly "suggests that the State's articulated rationale is not in fact the basis for the disparate treatment, but only a cloak for discrimination against federally funded benefits." *Barker v. Kansas*, 503

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the employee cannot qualify for the favored treatment. Stated another way, the favored treatment under Arizona law is based exclusively on the source of an employee's compensation.

[10] Arizona acknowledged this much in its *amici curiae* brief filed in this Court in *Harper v. Virginia Dep't. of Taxation*, 509 U.S. 86 (1993). The Arizona Solicitor General explained the fact that the exemption exists separate and apart from the provisions of the State's tax code:

> [T]he principal North Carolina and Arizona exemptions *were contained in the states' retirement plan statutes, not in their income tax laws. E.g.*, N.C. Gen. Stat. §§ 128-31; 135-9 (1986); former A.R.S. §§ 38-762(A) and 33-781.22(A).
>
> * * *
>
> The tax exemptions for state and local retirees were to all appearances legitimate employment benefits separate and apart from the seemingly wholly legitimate income taxes.

Brief *Amici Curiae* of the States of Arizona and North Carolina in support of *Virginia Department of Taxation*, U.S. No. 91-794, Sept. 8, 1992 at 22 (emphasis added).

U.S. 594, 604-05 (1992) (citation omitted). Review by this Court is necessary to ensure that states may not so easily escape their constitutional obligations when taxing the United States and those with whom it deals.

4. The court below justified Arizona's discriminatory tax by seeking to hide behind the Internal Revenue Code. Specifically, the court held that "nothing in the Arizona scheme discriminates between taxpayers based on the federal or non-federal source of income; instead the distinction is based on whether a particular state employer has voluntarily opted to pick up the employee contribution" as authorized by 26 U.S.C. § 414(h)(2). App. 18a. As noted above, this reasoning is fallacious—the only employees who can benefit under § 414(h)(2) are state and local employees. Thus, Arizona's saying that the discrimination is based on whether the employer "picks up" the contribution under § 414(h)(2) is no more compelling than saying the discrimination is based on whether the employer has the letter "z" in its name. In determining whether a tax violates the federal government's constitutional immunity, courts "must look through form and behind labels to substance." *Jefferson County v. Acker*, 527 U.S. 423, 439 (1999) (citation omitted). This the court below failed to do.

Moreover, as this Court held in *Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue*, 505 U.S. 71, 82 (1992), the "adoption of the federal system in whole or in part, however, cannot shield a state tax statute from [constitutional] scrutiny."[11] The court below eschewed *Kraft*, concluding that because it was a Foreign Commerce Clause case it was too far afield to be instructive in resolving these Supremacy Clause and intergovernmental tax immunity issues. App. 17a n.13. But

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[11] At present count a total of 43 states have adopted the federal system in whole or in part for purposes of either the personal or corporate income tax. App. 164a-166a.

nothing in either the holding or rationale of *Kraft* suggests that it should be so limited.

Accordingly, review by this Court is necessary to make clear that this important principle is not limited to the Commerce Clause. Otherwise, the decision below will provide a road map for States to nullify federal statutory and constitutional protections by invoking the simple expedient that they were merely adopting the Internal Revenue Code. This Court has never before accepted this excuse and it should not do so now.

CONCLUSION

For each of the above reasons, the petition should be granted.

Respectfully submitted,

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